FOMC Briefing
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While differences among the long-run alternatives for the aggregates shown in the blue book are arithmetically small, choice of one or the other does depend in part on the degree to which the Committee believes the greater risks this year and tending into next lie on the side of more inflation or on the side of inadequate real growth. As the material presented to the Committee implies, this is a particularly difficult period for making such judgments. In the fall of 1979, it was clear that inflation was the main problem. In the fall of 1982, the need to stimulate real growth was evidently the problem. But in the winter of 1986, there are more conflicting tendencies, though at the moment some may seem to be more latent than manifest.

The inflationary risks stem from three sources: First, the potential for a sharp further drop in the exchange value of the dollar should the world at large become notably less willing to finance our large current account deficit. Second, the possibility that the process of fiscal restraint will break down in practice, adding more to aggregate demand pressures than anticipated. And, third, as the unemployment rate continues to drop either because productivity is weak or economic growth is strong or both, there is the question of whether we are not nearing the point where upward wage pressures, with feedback effects on prices, will become more evident. These sources of inflationary risk can of course be offset, though only for a time, by the favorable effect on price indexes and possibly inflationary expectations of a significant further decline in the oil price should that develop and be passed through into retail prices.

Risks of unduly slow growth would seem to be based on: the possibility that substantial fiscal restraint will in fact develop without a more or less automatic compensating rise in private spending; the potential for adverse business attitudes should longer-term interest rates still seem high in real terms relative to real profit potential; and a possible adverse impact of debt burdens on consumer and institutional behavior. These risks may be offset over the period ahead by the positive effects on real domestic demand and on business attitudes of a sharp further drop in the dollar and a significant further drop in the oil price.

Of the longer-run alternatives presented, alternative II, which embodies the highest growth ranges, may in this context be construed as more consistent with a view that the risks of slow growth outweigh those of inflation. The other alternatives would represent more restraint against a resurgence of inflationary pressures because of the lower upper limits proposed for the M1 and M2 ranges. Alternative III includes the lowest limits, and might be viewed as taking the opportunity of a sharp drop in the oil price to secure associated anti-inflationary gains, with constraints on real growth, if any, relative to the nation's potential depending on the extent of price decline and other developments. Alternative I perhaps can be viewed as more evenly balancing the risks of inflation as against economic weakness.

Given the uncertainties in the current economic outlook, there would appear to be much to be said for avoiding signals that could be misinterpreted in either inflationary or deflationary directions in the market. The ranges of alternative I since they have already been tentatively adopted, and with the aggregates so far this year currently running within or quite near the ranges, would seem to bear least risk of such interpretation problems.

Alternative I as tentatively adopted, however, has an M1 range that is the same width as for M2 and M3. For the reasons noted in the blue book--including evidence that M1 may have become more interest sensitive than the broader aggregates--the Committee may wish to consider employing an M1 range that is broader than for the other aggregates. A 3-1/2 to 7-1/2 percent range would be symmetrical around the tentative 4 to 7 percent M1 range, as would the wider 3 to 8 percent range that is the same as had been adopted for the second half of 1985. The latter range would more tend to downplay the role of M1 in policy. On the other hand, the one point rise entailed in the tentative upper limit could also raise some questions about the anti-inflationary thrust of monetary policy--though that would probably be judged against the volatility of M1 in recent years.

Perhaps the prior question with respect to M1 is whether it should be reduced to a monitoring range or continue to have some weight in policy implementation. Recent evidence about M1 and its demand and indicator properties was presented to, and discussed by, the Committee at its December meeting. The evidence in my view is not entirely reassuring. We could explain a large part of the aberrant M1 behavior in the 1982-1983 period and in 1985 by responsiveness to interest rate changes, so that its demand properties have not been a complete mystery. However, M1 has not served well as an indicator of future GNP in recent years--indeed in part because institutional change has made the aggregate more interest elastic than it had been and also because interest rates have undergone a relatively sizable though bumpy downward adjustment in the transition toward a much lower rate of inflation.

While M1 itself may have become less reliable, at least in recent circumstances, that does not necessarily mean it is without significant value as a policy indicator when considered not in and by itself but as one of three monetary aggregates, including M2 and M3. We have continued with efforts to determine the conditions under which M1 foreshadows nominal GNP and when it doesn't. It does appear that M1 does a significantly better job of foreshadowing GNP when it is concordant with behavior of M2 and M3 (with M2 generally the more significant addition)--that is, when all three aggregates are behaving similarly relative to their recent trends M1 is much more likely to presage future GNP behavior relative to its recent trend. This is of course true for M2 as well. The collectivity of the aggregates in other words appears to have more significance for future GNP behavior than any one aggregate separately. Of course even when M1 and M2 are giving similar signals, there is still considerable looseness in their relationship to subsequent GNP movements. However, on average over the past 15 years each aggregate has been a significantly better precursor of GNP when it is concordant with the other aggregate than when it diverges or than when tests are run without reference to behavior of the other aggregate. In the latter respect, in the 1980's so far some tests show that M2 has done a little better on its own than M1, but in the 1970's on average M1 did a little better than M2.

These results--tentative as all results in this area must necessarily be in a period of institutional and economic change--suggest the desirability of retaining M1 along with other aggregates, with the relative weight of the aggregates in policy implementation largest when M1 and M2 are giving similar signals, judged of course in the context of other economic and financial developments. Such an approach seems generally in line with how the Committee in effect has been treating M1 over the past three years or so.